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TAGS: ECON EAID KMCA EFIN EINV SF
SUBJECT: SOUTH AFRICA: THE NEED AND PROSPECT FOR GROWTH

REF: A) Pretoria 1998 B) Pretoria 2161 C) Pretoria 2343

D) Pretoria 2621 E) Pretoria 2971 F) 04 Pretoria 171
G) 04 Pretoria 4809 H) 04 Pretoria 5007

¶1. (SBU) Summary: Fiscal and budgetary reforms of the past decade have built a firm foundation upon which the South African economy can build, but life for many South Africans has not improved much since the transition to majority rule in 1994. Widespread unemployment, rapid urbanization, and disease make South Africa home to one of the most impoverished populations in the world. The government knows that it cannot meet this challenge on the back of transfer payments alone. Last year, the executive branch decided that the way to achieve higher growth was through fiscal expansion and investment in infrastructure. It reserved a starring role for state owned enterprises and public-private partnerships. The hitch is that implementation hinges on improving the capacity and effectiveness of the public sector. The right kind of development assistance could help South Africa get the most bang for its buck, or a bigger bang from more bucks. End Summary.

Gauging Strengths .

¶2. (U) Most economists would argue that the fiscal and budgetary reforms of the past decade have built a firm foundation upon which the South African economy can build. The government has reduced and then stabilized its fiscal balance, brought inflation under control, modernized its tax structure, adopted policy-consistent planning and budgeting systems, deepened its credit markets, dismantled many exchange controls, lowered import tariffs, reduced non-tariff barriers, and redirected public spending in an effort to redress the inequality and poverty caused by the country's racially skewed past. There are clear signs that the economy is on the right track. The country has experienced its longest period of continuous growth in its recorded economic history, averaging 3.0% between 1994 and 2004. For 2004, interest rates reached their lowest levels in 20 years, inflation reached its lowest level since 1959, and the rate of GDP growth picked up to 3.7%.

and Weaknesses.

¶3. (U) While the ANC government can congratulate itself on having restructured the economy and achieved modest, but steady growth, life for many South Africans has not improved much since the transition to majority rule in ¶1994. Widespread unemployment, rapid urbanization, and disease make South Africa home to one of the most impoverished populations in the world. Fifty-seven percent of the population lives below the poverty line [defined here as a family of four living on less than $215 per month]. Though 2 million net jobs have been created over the last decade, a rapidly growing labor force has resulted in the rate of unemployment almost doubling during this period, disproportionately affecting blacks and "coloureds." About 2.8 million households, a quarter of the population, are still situated in impoverished settlements originally designed to warehouse a non-white population under apartheid. A rampaging HIV/AIDS epidemic has reduced life expectancy to 46 years in 2004 - down from 63 years in 1992 and well below the 69-year average for other lower middle-income countries. The precipitous decline in life expectancy has caused South Africa's to fall to 119 out of 177 countries in the 2004 Human Development Index. (Ref E)

¶4. (U) The government knows that if high unemployment persists, political discontent will be difficult to contain because unemployment is dramatically skewed along racial lines. Since 1994, scores of unemployed black South Africans and "coloureds" have migrated to cities in search of work, creating huge shantytowns on the

periphery. Some of these shantytowns have already become political powderkegs for municipal governments that have failed to deliver on the many promises of national government (Ref D). Economists and politicians increasingly refer to the broad measure of unemployment, which estimates unemployment to be 41%. Using this broad measure, almost 48% of black Africans and over 30% of "coloureds" are unemployed -- two racial categories that comprise 88% of the population (Refs E, F).

The Need for Growth

¶5. (U) The government faces formidable medium and long-term challenges to reduce unemployment, alleviate poverty, and eliminate the racial divisions that plague South African society. In 2004, policy makers concluded that that, while much had been accomplished to provide housing, electricity, water, and other services to the poor, the government could not overcome poverty through transfer payments alone. The government now spends 4.5% of GDP on child support, disability, and foster care grants - constituting one of the largest non-contributory income redistribution programs in the world. Further increases in transfer payments risk creating dependencies on government and attitudes of entitlement among the general population that will ultimately buckle the country's relatively small, modern economy. To eliminate extreme poverty and open employment paths to the modern economy, policy makers concluded that higher growth was needed, of a kind that generated employment opportunities for the poor and unskilled. Without faster economic growth, the country had little chance of alleviating poverty and virtually no chance of reaching the government's goal of halving unemployment by 2014.

¶6. (U) In his paper entitled, "The State Must Review Priorities and Step Up Performance" published in mid 2004, President Mbeki's Chief Economic Advisor Alan Hirsch argued that the major reason for South Africa's relatively modest growth compared to other emerging economies was South Africa's low level of fixed investment, which had fallen from 28% of GDP in the early 1980s to only 17% of GDP in early 2005. Hirsch noted that, over the last decade, the government and state-owned enterprises, such as Eskom (the electric utility) and Transnet (port, rail, and air transportation services), had actually consumed more capital than they had contributed. The result was the gradual deterioration of the nation's infrastructure, greater inefficiency embedded in the economy and, in some cases, a loss of international competitiveness for South African businesses. Hirsch argued that South Africa needed to raise the level of fixed investment to 20-25% of GDP (similar to South Korea and Australia) to drive the kind of growth the country needed to successfully reduce unemployment and alleviate poverty. As it stood, public sector fixed investment had declined from a peak of about 16% of GDP in the late 1970s to 4% in early 2004. While domestic private sector investment was holding its own -- even growing at a healthy rate -- it would not be sufficient to spawn rapid growth in the near term without increases in foreign direct and/or public sector investment. (Ref G)

If You Build It, They Will Come

¶7. (U) Hirsch observed that, with the exception of mining and manufacturing, South Africa had not been able to attract the level of foreign direct investment (FDI) as had its peer countries. In 2003, South Africa attracted just $820 million in FDI, much less than Poland and Chile, which attracted over $4 billion and $3 billion, respectively. Often cited reasons have been the high degree of concentration of ownership in some sectors in South Africa, labor market rigidities, affirmative action policies, a volatile exchange rate, a high crime rate, relatively high interest rates, the low rate of domestic growth, social inequality and the perceived will and capacity of government to deal its many problems. While policy makers, including Hirsch, recognized that "microeconomic reforms" would be needed to address some of these issues, they generally concluded that foreign investors would come to South Africa once domestic growth picked up.

The Plan for Growth

¶8. (U) Given this analysis, policy makers concluded that the government should pursue a policy of fiscal expansion to promote faster economic growth through greater public sector investment. The ensuing plan was clearly articulated by Manuel in his Medium Term Budget Policy Statement in October 2004. Manuel declared that the government's goal was to increase the rate of fixed

investment from 16% of GDP to 25% by 2014 in an effort to produce a 6% rate of growth. Most of the increase in fixed investment would come from state-owned enterprises and public-private partnerships. State-owned enterprise investment would expand by at least 20% over the next five years. General government would expand fixed investment by about 7% a year over the next three years. An "Expanded Public Works Program" would create one million temporary jobs in a range of sectors over the next five years. Public sector borrowing would increase from under 1% of GDP in 2002 to 4.6% in 2007; interest on public debt would ultimately stabilize at around 4.5% of GDP. (Ref H)

¶9. (U) Manuel reserved a starring role for Eskom and Transnet, state owned enterprises that the government would spare from privatization for the time being. Eskom would spend up to $16 billion on new power plants and the expansion of its transmission network. Transnet would spend up to $7 billion in port projects and almost $1 billion on the refurbishment of 24,000 freight rail wagons. These investments would create jobs, stimulate economic growth, and raise the competitiveness of export related industries. (Ref B)

¶10. (U) Manuel also reserved a starring role for national, provincial, and municipal government to entice the private sector to invest alongside government through an extensive program of public-private partnerships. Guidelines were issued and a unit created in Treasury to govern the process. Treasury projected an increase in capital spending associated with public-private partnerships, from about $300 million in 2003 to about $800 million in 2007. (Ref A)

Challenges

¶11. (U) A successful public sector-led growth strategy will hinge on the ability of government and state owned enterprise to implement it. President Mbeki has readily conceded that the "Achilles heel" of his effort to transform South Africa is the shortage of skilled persons to carry out needed reforms and implement government programs. In June, Minister of Provincial and Local Government Sydney Mufamadi admitted to Parliament that 136 of 284 municipalities were "under performing." [Note: The exact definition of "under-performing has not been made public, but is likely to include the inability to deliver basic services, shrink the housing backlog, disburse funds, and file reports to provincial and national government in accordance with the Municipal Financial Management Act. End Note.] State owned enterprises have had their own management difficulties, making Minister of Public Enterprises Alec Erwin's central mission to ensure that these enterprises are strong enough to accomplish government's objectives (Refs B and D).

¶12. (U) Recently, rigid labor policies have become a public policy concern. Companies seem to avoid hiring because of the costs and legal obligations that it imposes. As a result, the most successful firms in South Africa continue to be those that are capital intensive, such as metals processing, chemicals, and pulp and paper. Labor-intensive industries such as clothing and textiles, footwear, food processing, wood and wood products are for the most part weak competitors against cheap imports. A debate has been initiated on how to make it easier to hire unskilled workers. There is concern that government training programs are not effective in meeting the demand for skilled labor.

¶13. (U) In June 2005, the ANC released a controversial document, penned by Deputy Minister of Finance Jabu Moleketi, entitled "Development and Underdevelopment - Learning from Experience to Overcome the Two Economy Divide" that suggested a more flexible labor regime. Proposals included waiving minimum wage and other collective bargaining arrangements for younger workers, establishing a separate regime for certain sectors such as tourism, textiles and clothing, agriculture, small and medium enterprises, as well as household and child care, and establishing a separate regime for industrial development zones. The document evoked considerable criticism from the union and communist wings of the ANC at its National General Council Meeting in July 2005. The political jury is still out. (Ref C)

¶14. (U) On July 24 2005, after a three-day cabinet retreat, President Mbeki publicly embraced the 6% growth target and announced the formation of a high-level economic task force headed by Deputy President Phumzile Mlambo-Ngcuka to find ways to achieve it. Task force members include Finance Minister Trevor Manuel, Trade and Industry Minister Mandisi Mpalhwa, and the premiers from

Guateng and Eastern Cape Provinces. They are charged with proposing ways to speed up growth and job creation in time for the Medium Term Expenditure Framework due in Parliament in October.

Comment: The Prospect for Growth

¶15. (SBU) A growth rate of 3.7% created a net 168,000 jobs for the economy in 2004, but economists agree that job growth will have to be considerably higher to make a real dent in unemployment. Most economists agree that an average annual growth rate in the neighborhood of 6% or more would be needed to reduce unemployment and poverty in half by 2014. Hirsch and other policy makers assume that a 25% fixed investment to GDP ratio would be required to achieve 6% growth, but do not see it happening until 2014. The Department of Treasury expects growth to be 4.3% in 2005 and to average 4.2% per year over the next three years.

¶16. (SBU) While the level of fixed investment needed to stimulate higher growth and significantly reduce unemployment can be debated, the shear volume of public sector investment that the government is prepared to push onto the economy is bound to stimulate growth above the country's ten year average of 3.0%, reduce unemployment levels, and hopefully the number of people living in poverty. The real question is "How much bang for the buck will the government get?"

¶17. (SBU) Prospects for short-term success would improve if municipalities were better able to manage their public-private partnerships, if state owned enterprises were better managed, and if there were better skills development programs for the unemployed. Prospects for long-term success and the trajectory for growth would improve if the government could afford more fixed investment in the early years. This leads us to conclude that foreign development assistance that added to the size of the stimulus in the early years, or to the ability of government to manage the stimulus, would go a long way in helping South Africa achieve higher, sustainable growth, reduce unemployment, and alleviate poverty sooner rather than later. Given that South Africa is perhaps the only real engine of growth for sub-Saharan Africa, we would like to see that happen sooner.